BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-497-PD
GARY 0. ARMSTRONG)

Appearances:

For Appellant: Gary 0. Armstrong, in pro. per.

For Respondent: James T. Philbin, Supervising Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Gary 0. Armstrong against proposed assessments of additional personal income tax plus penalties in the total amounts of $939.02, $557.21, $799.44, $2,666.44, $5,356.41, and $1,319.50 for the years 1971, 1973, 1975, 1976, 1979, and 1980, respectively.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

Appeal of Gary 0. Armstrong

At issue in this appeal is (1) whether appellant has demonstrated error in respondent's assessments of tax and of penalties for failure to file timely returns and failure to file returns after notice and demand, and (2) whether respondent has demonstrated by clear and convincing evidence that appellant fraudulently intended to evade the tax.

Appellant made a previous appeal to this board from respondent's assessments for the years 1970, 1971, 1972, 1973, 1974, 1977, and 1978, for which appellant failed to file tax returns. (Appeal of Gary 0. Armstrong, Cal. St. Bd. of Equal., Dec. 10, 1981.) Later, appellant was convicted of failing to file state income tax returns for 1971 through 1974, fined, placed on probation, ordered to pay his income tax for 1971 through 1974 and, apparently, to file returns due for later years. Appellant then filed returns for the years 1971 through 1980. After receiving those returns, respondent met with appellant's representative for an audit of the returns, and later issued proposed assessments which disallowed reported losses and deductions because of a lack of substantiation. The proposed assessments included penalties for failure to file on time (section 18681), failure to file after notice and demand (section 18683) and fraud (section 18685). Appellant protested. After requesting several hearing postponements, appellant's representative failed to appear, and respondent affirmed its proposed assessments.

When notices of action were sent to appellant, respondent made errors on the notices of action for 1979 and 1980. For 1980, respondent's notice showed taxable income as reported when it intended to show taxable income as revised and it did not show any tax liability to support the penalties shown on the notice:- Respondent concedes this notice was in error and no longer asserts the propriety of the penalties shown on that notice of action. Similarly, respondent did not include a fraud penalty on the notice of action for 1979 and likewise no longer asserts the propriety of a fraud penalty for that year.

Appellant's letter of appeal alleges that the personal income tax is an excise tax, that an excise tax is a tax on commodities, and that appellant is not engaged in the sale of any commodities subject to that tax. The letter also refers to several parts of the United States Constitution. But the letter does not

discuss directly the amounts of tax or the penalties assessed.

It is well established that the taxpayer who claims a deduction has the burden of proving that he is entitled to that deduction. A determination by respondent that a deduction should be disallowed is supported by a presumption that it is correct. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 13481 (1934); Appeal of Nake M. Ramrany, Cal. St. Bd. of Equal., Feb. 15, 1972.) Appellant has offered nothing to support the claimed deductions and has limited his written arguments on appeal to constitutional, references which appear to be general attacks on California's power to impose a personal income tax. (Cf. Appeal of Fred R. Dauberger, et al., Cal. St. Bd. of Equal., Mar. 31, 1982.) Therefore, we must conclude that respondent's action in disallowing the unsubstantiated deductions was proper. Likewise, respondent's application of the penalties for failing to file a timely return and for failure to file a return upon notice and demand have not been effectively challenged by appellant, so with the exception of those penalties imposed for 1980 conceded by respondent, we must affirm those penalties.

With respect to the fraud penalties assessed against appellant, the burden of proving fraud is upon respondent, and the fraud must be established by clear and-convincing, evidence. (Valetti v. Commissioner, 260 F.2d 185, 188 (3d Cir. 1958); Appeal of George W. Fairchild, Cal. St. Bd. of Equal., Oct. 27, 1971.) Fraud implies bad faith, intentional wrongdoing, and a sinister motive; the taxpayer must have the specific intent to evade a tax believed to be owing. (Jones v. Commissioner, 259 F.2d 300 (5th Cir. 1958); Powell v. Granquist, 252 F.2d 56 (9th Cir. 1958).) Although fraud may be established by circumstantial evidence (Powell v. Granquist, supra) it is never presumed or imputed, and it will not be sustained upon circumstances which, at most, create only suspicion. -(Jones v. Commissioner, supra.)

Section 18685 provides for the assessment of a civil fraud penalty "[i]f any part of any deficiency is due to fraud with intent to evade tax." As this section is similar to its federal counterpart (Internal Revenue Code of 1954, section 6653(b)), federal case law is persuasive in the interpretation and application of the California statute. (Holmes v. McColgan, 17 Cal.2d 426, 430 [110 P.2d 428], cert. den., 314 U.S. 636 [86 L.Ed. 510] (1941).) Circumstantial evidence may be used by

respondent to carry its burden of proving fraud by clear and convincing evidence. (Cal. Admin. Code, tit. 18, reg. 5036; Appeal of Richard A. and Virginia R. Ewert, Cal. St. Bd. of Equal., Apr. 7, 1964; Appeal of Herbert Tuchinsky, Cal. St. Bd. of Equal., July 1, 1970.)

Respondent previously imposed civil fraud penalties for the years 1971 through 1974. We sustained that action of respondent in the Appeal of Gary O. Armstrong, decided December 10, 1981. In that decision, we relied on appellant's previous felony convictions for failure to file state income tax returns with intent to evade taxation for those years as constituting prima facie evidence that appellant's underpayment of tax was due to (civil) fraud as well as collaterally estopping appellant from challenging respondent's imposition of those penalties for those years. We believe that respondent's imposition of increased fraud penalties for 1971 and 1973 following its inspection of appellant's late returns for those years and based upon its finding of increased understatements if tax for those years, must be sustained for the reasons set forth in our opinion on this appellant's previous appeal for those years. (Appeal of Gary 0. Armstrong, supra.)

There remains for review the fraud penalties which respondent assessed for 1975 and 1976. Respondent imposed the. fraud penalty for those years on the basis that on appellant's late returns, he claimed large deductions which he failed to substantiate upon audit. Appellant was an employee whose wages were his primary source of income. He claimed large business losses unsubstantiated by a Schedule C or any other indentification of that business activity. His claimed business losses in 1975 were $38,364 and in 1976 were $39,524. A large unidentified loss carryover was claimed for 1976, but such a carryover was unallowable for state purposes. Appellant was not convicted of criminal tax fraud for those years. The fact that an individual's conduct was proved fraudulent in one year does not justify a conclusion that he fraudulently evaded his tax obligations in another.year. (Appeal of Robert V. Erilane, Cal. St. Bd. of Equal., Nov. 12, 1974,)

To support the fraud penalty it imposed for 197'5 and 1976, respondent points to the fact that appellant had previously failed to file returns and filed returns only when faced with a court imposed jail sentence as an immediate alternative. But we cannot conclude that a demonstrated resistance to filing complete returns

constitutes clear and convincing evidence that deductions taken on those returns when finally filed were fraudulent simply because the taxpayer failed to substantiate those deductions upon later demand by respondent.

Based upon a review of this matter and a finding that the appeal was frivolous, we conclude that a $500 penalty under section 19414 should be imposed.

0 RD E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Gary 0. Armstrong against proposed assessments of additional personal income tax, including penalties, in the total amounts of $939.02, $557.21, $799.44, $2,666.44, $5,356.41, and $1,319.50 for the years 1971, 1973, 1975, 1976, 1979, and 1980, respectively, be and the same is hereby (1) modified to reflect respondent's concession with respect to' the penalties for 1979 and 1980, and (2) reversed with respect to the assessment of fraud penalties in the amounts of $199.86 and $666.62 for the years 1975 and 1976, respectively. In all other respects, the action of the Franchise Tax Board is sustained. In addition, a $500 penalty under section 19414 shall be imposed.

Done at Sacramento, California, this 3rd day of December, 1985, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

_____, Chairman.

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9